DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 07-0075
Gross Retail Tax
For the Years 2003, 2004, and 2005

NOTICE: Under IC § 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. **Service/Rental Transactions** – Gross Retail Tax.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-4-1; IC § 6-8.1-5-1(b); 45 IAC 2.2-4-27; 45 IAC 2.2-4-27(d)(3)(B).

Taxpayer argues that the Department mistakenly assessed use tax on service transactions.

II. **Manufacturing Machinery and Tools** – Gross Retail Tax.

Authority: IC § 6-2.5-5-3; IC § 6-2.5-5-3(b); 45 IAC 2.2-5-8(c)(2)(B); 45 IAC 2.2-5-8(c)(2)(E); 45 IAC 2.2-5-8(f)(3); 45 IAC 2.2-5-8(h)(2); 45 IAC 2.2-5-8(i); *Indiana Dept. of State Revenue v. Cave Stone, Inc.*, 457 N.E.2d 520 (Ind. 1983); *General Motors Corp. v. Indiana Dept. of State Revenue*, 578 N.E.2d 399 (Ind. Tax Ct. 1991); *Mumma Bros. Drilling Co. v. Indiana Dept. of Revenue*, 411 N.E.2d 676 (Ind. Ct. App. 1980).

Taxpayer maintains that the Department erroneously assessed use tax on exempt purchases of items directly used in the direct production of taxpayer's chemical products.

III. **Fabrication Equipment** – Gross Retail Tax.

Authority: IC § 6-2.5-5-4; IC § 6-8.1-5-1(b).

Taxpayer states that it is entitled to an exemption for the purchase of fabrication equipment used to produce its production equipment.

IV. **Raw Materials** – Gross Retail Tax.

Authority: IC § 6-2.5-5-4; IC § 6-2.5-5-6(b); IC § 6-8.1-5-1(b).

Taxpayer argues that the raw materials it purchased are exempt from the gross retail tax.

V. Environmental Control Purchases – Gross Retail Tax.

Authority: IC § 6-2.5-5-30; IC § 6-8.1-5-1(b).

Taxpayer states it purchased exempt materials and equipment for the purpose of complying with federal, state, or local environmental regulations.

VI. Non-Returnable Packaging – Gross Retail Tax.

Authority: IC § 6-2.5-5-9; IC § 6-8.1-5-1(b).

Taxpayer maintains that it is entitled to a refund of sales tax on the purchase of non-returnable packaging materials.

VII. Ten-Percent Negligence Penalty.

Authority: IC § 6-3-6-10(a); IC § 6-8.1-10-2.1(3); IC § 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer argues that it is entitled to an abatement of the ten-percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is an Indiana chemical manufacturer. According to taxpayer its "production process consists of a series of steps that include measuring, combining, mixing, heating, and testing the product" with the final production process consisting of "packaging of the product."

The Department of Revenue (Department) conducted an audit of taxpayer's records. The audit found that taxpayer made purchases without paying sales tax and that taxpayer failed to self-assess use tax. Although taxpayer was given limited credit for overpayments of withholding and sales tax, taxpayer was assessed additional use tax. Taxpayer disagreed with the bulk of the assessment and submitted a protest to that effect. An administrative hearing was conducted during which taxpayer's representative attempted to explain the basis for the protest. Thereafter, taxpayer requested and was granted an additional 30 days in which to present additional documentation. When that initial extension of time proved to be insufficient, taxpayer requested and was granted another 30 days to provide the supplemental documentation. This Letter of Findings results.

I. **Service/Rental Transactions** – Gross Retail Tax.

DISCUSSION

Taxpayer argues that the Department erred when it determined that "Various tools and equipment were rented to be used outside the production process mainly in the construction of a new building." According to taxpayer, the transactions at issue were for services that were not subject to Indiana gross retail tax.

Indiana imposes a gross retail (sales) tax on retail transactions in Indiana. IC § 6-2.5-2-1. 45 IAC 2.2-4-27 provides the starting point for determining the taxability of transactions for the rental of tangible personal property. That section states "[i]n general, the gross receipts from renting or leasing tangible personal property are taxable." An exception to that general rule is found at 45 IAC 2.2-4-27(d)(3)(B) which states "[t]he rental of tangible personal property together with an operator as part of a contract to perform a specific job in a manner to be determined by the owner of the property or the operator *shall be considered the performance of a service rather than a rental* or lease provided the lessee cannot exercise control over such property and operator." (*Emphasis added*). The exemption is clearly qualified and limited to those transactions in which the lessee (taxpayer) does not exercise control over the manner in which the crane operator conducts the work.

Nonetheless, taxpayer contends that the transactions are evidence of purely service contracts and cites to IC § 6-2.5-4-1 to establish that the transactions are entirely exempt. The cited statute reads as follows:

> (a) A person is a retail merchant making a retail transaction when he engages in selling at retail. (b) A person is engaged in selling at retail when, in the ordinary course of his regularly conducted trade or business, he:
>
> (1) acquires tangible personal property for the purpose of resale; and
>
> (2) transfers that property to another person for consideration.

IC § 6-8.1-5-1(b) provides the presumption which taxpayer must overcome. That section states that, "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

Taxpayer has provided 87 invoices totaling approximately $90,000 which purport to establish that the underlying transactions are exempt. However, the Department is unable to agree that the documents provided meet the standard set out in IC § 6-8.1-5-1(b). Despite the fact that the "invoices" are from multiple vendors, represent transactions which occurred in different years, each pristine invoice is identically formatted and printed in an identical font. There is no indication that the proffered documents were provided at the time the audit was conducted or that the documents are contemporaneous

with the original transactions between the taxpayer and the vendors. Taxpayer has offered nothing to substantiate the reliability or accuracy of the documentation.

FINDING

Taxpayer's protest is denied.

II. Manufacturing Machinery and Tools – Gross Retail Tax.

DISCUSSION

Taxpayer challenges the assessment of and the lack of credit for "exempt manufacturing machinery, tools, and equipment used in an exempt manner." Specifically taxpayer cites to IC § 6-2.5-5-3 which states that:

> Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for his direct use in the direct production of the machinery, tools, or equipment described in section 2 or 3 of this chapter.

According to taxpayer, "Machinery, tools, and equipment that meet this standard fall into a number of different categories." Taxpayer continues stating that "many of the manufacturing exemptions do not require that the exempt property touch work-in process in order to qualify for the exemption." For clarity and convenience sake, this Letter of Findings will mirror the taxpayer's categorization of the ostensibly exempt items.

A. Electrical Distribution Equipment.

Taxpayer argues that its electrical distribution equipment is exempt. Taxpayer cites to 45 IAC 2.2-5-8(c)(2)(B) which reads as follows:

> An electrical distribution system, including generators, transformers, electrical switchgear, cables inside or outside the plant, and related equipment used to produce and/or supply electricity to exempt manufacturing equipment used in direct production.

According to taxpayer it "uses various types of electrical distribution equipment within its facility to produce and supply electricity to exempt manufacturing equipment used in direct production." Taxpayer concludes that the designated electrical distribution equipment is exempt.

B. Items Used to Support Production Equipment.

Taxpayer argues that certain "items used to support production equipment" are exempt and cites to 45 IAC 2.2-5-8(c)(2)(E) which reads as follows:

> A work bench used in conjunction with a work station or which supports production machinery within the production process.

Taxpayer concludes that "steel beams and sheet metal support production machinery used during the production process" are exempt. Taxpayer argues that the structural items are "required for the production process to take place."

C. Equipment Used to Transport Work-in-Process.

Taxpayer "protests the lack of credit given for Indiana gross retail tax paid in error on tangible personal property used to transport work-in-process. According to taxpayer, it paid sales tax on "forklift trucks [used] to transport work-in-process" and cites to 45 IAC 2.2-5-8(f)(3) which reads as follows:

> Transportation equipment used to transport work-in-process or semi-finished materials to or from storage is not subject to tax if the transportation is within the production process.

Taxpayer concludes that it is entitled to a credit for the sales tax when it purchased the forklift trucks.

D. Replacement Parts.

Taxpayer "protests the assessment of a lack of credit given for exempt replacement parts" and cites to 45 IAC 2.2-5-8(h)(2) which reads as follows:

> Replacement parts, used to replace worn, broken, inoperative, or missing parts or accessories on exempt machinery and equipment, are exempt from tax.

Taxpayer maintains the audit's assessment of tax on these "exempt replacement parts" was erroneous and that the audit's decision to deny a credit for the sales tax when it purchased the "exempt replacement parts" was equally erroneous.

E. Testing and Inspection Equipment.

Taxpayer "protests that assessment of and lack of credit given for exempt testing and inspection equipment" and cites to 45 IAC 2.2-5-8(i) which reads as follows:

> Testing and inspection. Machinery, tools, and equipment used to test and inspect the product as part of the production process are exempt.

Taxpayer maintains the audit's assessment of tax on the "testing and inspection equipment" was erroneous and that the audit's decision to deny a credit for the sales tax when it bought the "testing and inspection equipment" was equally erroneous.

The Legislature has granted Indiana manufacturers a sales tax exemption for certain purchases. IC § 6-2.5-5-3(b) states, "Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring the property acquires it for *direct* use in the *direct* production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property." (*Emphasis added*). However, in enacting the stringently worded exemption, the Legislature clearly did not intend to create a global exemption for any and all equipment which a manufacture purchased for use within its manufacturing facility. "Fairly read, the exemption was meant to apply to capital equipment that [meets] the 'double direct' test." *Mumma Bros. Drilling Co. v. Department of Revenue*, 411 N.E.2d 676, 678 (Ind. Ct. App. 1980). The capital equipment "in order to be exempt, (1) must be *directly* used by the purchaser and (2) be used in the *direct* production, manufacture, fabrication, assembly, extraction, mining, processing, refining or finishing of tangible personal property." *Indiana Dept. of State Revenue v. Cave Stone, Inc.*, 457 N.E.2d 520, 525 (Ind. 1983) (*Emphasis added*). "[T]he test for directness requires the equipment to have an 'immediate link with the product being produced.'" *Id*. Accordingly, the sales tax exemption is applicable to that equipment which meets the "double direct" test and is "essential and integral" to the manufacture of taxpayer's tangible personal property. *General Motors Corp. v. Indiana Dept. of State Revenue*, 578 N.E.2d 399, 401 (Ind. Tax Ct. 1991).

In determining whether taxpayer's own purchases fall within the statute's boundaries – as with all tax exemptions – "[t]he taxpayer claiming [the] exemption has the burden of showing the terms of the exemption statute are met." *Id*. at 404. (Internal citations omitted). "Exemption statutes are strictly construed because an exemption releases property from the obligation of bearing its fair share of the cost of the government." *Id*.

As noted above, taxpayer essentially cited to the various permutations of the exemption provisions and provided a "Listing or Protested Audit Assessment Items" along with a "Listing of Sales Tax Overpayments" detailing hundreds of purportedly exempt items. In addition, taxpayer provided an "Affidavit" which restates the generalized assertions set out in the initial protest documents.

Following the administrative hearing, taxpayer was provided another 60 days in which to provide more detailed and specific information substantiating its protest. Taxpayer eventually provided a four-page "site plan of [taxpayer's] completed project and a detailed drawing of the production area" along with a two-page explanatory letter. In that letter, taxpayer concludes that, "All of our equipment is connected together and operates as a unit."

Based upon the information provided by taxpayer, the Department must conclude that the taxpayer is seeking a global exemption for all the equipment contained within its facility because – as taxpayer explains – it "consider[s] the *entire plant* as ou[r] manufacturing equipment." (*Emphasis added*).

Taxpayer has failed to meet its burden of demonstrating that the audit's determinations – distinguishing between equipment and supplies falling inside and outside the exemption's boundaries – were unreasonable or unjustified by either fact or law. Taxpayer has properly cited to the relevant statutory and regulatory exemptions but has done nothing other than make a bare assertion that specific items of purportedly exempt equipment fall within one of the exemptions. Taxpayer is entitled to its view that everything in its facility is exempt, but the Department is not inclined to agree.

FINDING

Taxpayer's protest is denied.

III. Fabrication Equipment.

DISCUSSION

Taxpayer argues that it is entitled to an exemption for fabrication equipment used in its production process. Taxpayer cites to IC § 6-2.5-5-4 which reads as follows:

> Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for his direct use in the direct production of the machinery, tools, or equipment described in section 2 or 3 of this chapter.

Taxpayer lists various items such as "cutoff wheel," "welded pipe nipple," or "backing pad for hook n loop disc." Taxpayer apparently concludes that citation to IC § 6-2.5-5-4 accompanied with a laundry list of specific items is sufficient to justify exempting the items. The Department must disagree. Taxpayer has not met the burden of proof set out in IC § 6-8.1-5-1(b) necessary to conclusively establish that the cited items are directly used "in the direct production of the machinery, tools, or equipment described in section 2 or 3 of this chapter." IC § 6-2.5-5-4.

FINDING

Taxpayer's protest is denied.

IV. Raw Materials – Gross Retail Tax.

DISCUSSION

Taxpayer protests "the assessment of tax and the lack of credit for tax paid on materials incorporated into [taxpayer's] final product, commonly referred to as raw materials." In support, taxpayer cites to IC § 6-2.5-5-6(b) which reads as follows:

> Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for direct consumption as a material to be consumed in the direct production of other tangible personal property in the person's business of manufacturing, processing, refining, repairing, mining, agriculture, horticulture, floriculture, or arboriculture.

Taxpayer lists various items such as "research 10 lb undecylenic acid," and "1 gallon sample." Taxpayer apparently concludes that citation to IC § 6-2.5-5-4 accompanied with a laundry list of specific items is sufficient to warrant exempting the items. The Department must disagree. Taxpayer has not met the burden of proof set out in IC § 6-8.1-5-1(b) necessary to conclusively establish that the cited items are directly "consumed in the direct production of other tangible personal property in the person's business of manufacturing, processing, refining, repairing, mining, agriculture, horticulture, floriculture, or arboriculture." IC § 6-2.5-5-6(b).

FINDING

Taxpayer's protest is denied.

V. **Environmental Control Purchases** – Gross Retail Tax.

DISCUSSION

Taxpayer "protests the assessment of and lack of credit given for exempt environmental control purchases." In support, taxpayer cites to IC § 6-2.5-5-30 which reads as follows:

> Sales of tangible personal property are exempt from the state gross retail tax if: (1) the property constitutes, is incorporated into, or is consumed in the operation of, a device, facility, or structure predominantly used and acquired for the purpose of complying with any state, local, or federal environmental quality statutes, regulations, or standards; and (2) the person acquiring the property is engaged in the business of manufacturing, processing, refining, mining, or agriculture.

Taxpayer points to a lengthy list of purchases for "PSI limestone mix" and "PSI pea gravel mix, grout mix" as qualifying for the exemption set out in IC § 6-2.5-5-30.

The Department notes that taxpayer operates a chemical processing plan that is apparently "highly regulated by IDEM, OSHA, and The Building Commission." However, taxpayer has not met the burden of proof set out in IC § 6-8.1-5-1(b) necessary to conclusively establish that the purchases of limestone, pea gravel, and grout "constitute[], [are] incorporated into, or [are] consumed in the operation of, a device,

facility, or structure predominantly used and acquired for the purpose of complying with any state, local, or federal environmental quality statutes, regulations, or standards." IC § 6-2.5-5-30.

FINDING

Taxpayer's protest is denied.

VI. Non-Returnable Packaging – Gross Retail Tax.

DISCUSSION

Taxpayer "requests a refund of Indiana gross retail tax paid in error on the purchase of non-returnable packaging materials. Taxpayer cites to IC § 6-2.5-5-9 which reads as follows:

> Sales of wrapping material and empty containers are exempt from the state gross retail tax if the person acquiring the material or containers acquires them for use as nonreturnable packages for selling the contents that he adds.

Taxpayer has failed to meet its burden of proof set out in IC § 6-8.1-5-1(b) necessary to establish that it purchased "non-returnable packaging materials" and that it paid sales tax on those specific items.

FINDING

Taxpayer's protest is denied.

VII. Ten-Percent Negligence Penalty.

DISCUSSION

Taxpayer argues that imposition of the ten-percent negligence penalty is inappropriate and that the Department should exercise its authority to abate the penalty. Taxpayer maintains that it has "provided a bona fide interpretation of the controlling authority for the overwhelming majority of the assessment" that it "has made a good faith attempt to pay tax on all subject items," and that "this audit is the first Indiana sales and use tax audit performed on [taxpayer]."

IC § 6-8.1-10-2.1(3) requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence.

Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable

taxpayer." Negligence is to "be determined on a case by case basis according to the facts and circumstances of each taxpayer." Id.

IC § 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

The Department is unable to agree that taxpayer is entitled to abatement of the penalty. According to the audit progress report, "taxpayer has previously been audited and did not put in place any type of use tax assessment" and that the "use tax assessment is substantial and no attempt was made to remit." A review of the records indicates that taxpayer has previously been audited for sales and use tax. There is little that would permit a conclusion that taxpayer "exercised ordinary business care and prudence."

FINDING

Taxpayer's protest is denied.

DK/JR/BK – January 2, 2008.